

Letter of Findings: 02-20150440
Corporate Income Tax
For The Tax Years 2007, 2008, 2009, and 2010

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Companies conducting business in Indiana provided some but not sufficiently usable and verifiable records as required by the federal and Indiana statutes and regulations to substantiate their "Wage for qualified Services" and "Cost of Supplies" for the tax years 2007, 2008, 2009, and 2010. Companies thus were not entitled to the Indiana Research Expense Tax Credit for those years.

ISSUE

I. Corporate Income Tax - Imposition - Indiana Research Expense Tax Credit.

Authority: I.R.C. § 41; I.R.C. § 63; IC § 6-3-1-3.5; IC § 6-3-1-11; IC § 6-3-2-1; IC § 6-3-2-2; [IC 6-3-3](#); [IC 6-3.1-4](#); IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Miller Brewing Co. v. Indiana Dep't of State Revenue*, 903 N.E.2d 64 (Ind. 2009); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); Treas. Reg. § 1.41-4; Internal Revenue Service, Large & Mid-Size Business Division, Office of Pre-Filing & Technical Guidance, *Research Credit Technical Advisor Program, Briefing Paper on Taxpayer Approaches to Capturing Costs for the Research Credit* (May 24, 2004); Letter of Findings 01-20150385 (December 12, 2016).

Taxpayers claimed that the Indiana Department of Revenue erred in disallowing their Indiana Research Expense Tax Credit, in the amount of \$1.63 million dollars, for 2007, 2008, 2009, and 2010.

STATEMENT OF FACTS

Taxpayer is a parent company of an American multinational conglomerate, which provides high technology products and services to building systems and aerospace industries, both domestically and worldwide. Taxpayer's business consists of two separate and distinct businesses: (1) commercial business and (2) aerospace business. Taxpayer and its subsidiaries ("Taxpayers") file Indiana corporate income tax on a consolidated basis.

Taxpayers claimed that they had conducted qualified research activities in Indiana and had incurred approximately \$1.63 million dollars of the Indiana Research Expense Credits ("RECs") in 2007, 2008, 2009, and 2010 ("Tax Years at Issue") in their original Indiana consolidated income tax returns for the Tax Years at Issue. The Indiana RECs, which claimed by Taxpayers, included "Wage for qualified Services" and "Cost of Supplies."

Beginning in late 2013, the Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayers' business records and returns for the Tax Years at Issue. The audit was not able to verify Taxpayers' Indiana RECs. Pursuant to the audit, the Department disallowed Taxpayers' Indiana RECs, resulting in additional income tax, interest, and penalty.

Taxpayers protested the Department's disallowance. An administrative phone hearing was held. Taxpayers requested additional time to submit additional supporting documentation. This Letter of Findings results. Additional facts will be provided as necessary.

I. Corporate Income Tax - Imposition - Indiana Research Expense Tax Credit.

DISCUSSION

Taxpayers protested the audit's disallowance, stating that they were entitled to the Indiana RECs. Taxpayers claimed the Indiana RECs, in the total amount of \$1.63 million dollars, in their original 2007, 2008, 2009, and 2010 Indiana corporate income tax returns.

The audit disallowed Taxpayers' Indiana RECs because the Department was not able to verify the qualified expenses, such as wages for qualified activities and qualified costs of supplies, which Taxpayers claimed they incurred in Indiana during the Tax Years at Issue. The audit, in relevant part, stated, as follows:

Throughout the course of the audit, auditor made multiple requests for documentation to verify these credits. Taxpayer[s] explained the difficulties of obtaining this information, that one of the companies responsible for claiming the credit [] was sold shortly after the current period. As a result, the records that substantiate the credit were not available

It should be noted that, after the administrative hearing, Taxpayers requested additional time to submit additional supporting documentation. In their May 31, 2017 letter, Taxpayers further argued that they estimated that they had incurred approximately \$6 million-dollars of qualified expenses and thus were entitled to the Indiana RECs for that amount for the Tax Years at Issue according to its own post-hearing calculation. Taxpayers did not properly file any claim for refund in that regard and the Department has not had any opportunity to examine the validity of this new claim made by Taxpayers in their post-hearing letter. Thus, for the purpose of this protest, the issue is whether Taxpayers provided sufficient documentation to substantiate their claimed - approximately \$1.63 million dollars - Indiana RECs for the Tax Years at Issue, which was disallowed pursuant to the Department's audit.

Indiana mandates that every person who is subject to a listed Indiana tax must keep books and records, including all source documents, "so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a). "If the [D]epartment reasonably believes that a person has not reported the proper amount of tax due, the [D]epartment shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the [D]epartment." IC § 6-8.1-5-1(a). All tax assessments are *prima facie* evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). "Each assessment and each tax year stands alone." *Miller Brewing Co. v. Indiana Dep't of State Revenue*, 903 N.E.2d 64, 69 (Ind. 2009). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "all statutes are presumptively constitutional." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 587 (Ind. 2014) (citing *UACC Midwest, Inc. v. Indiana Dep't of State Rev.* 629 N.E.2d 1295, 1299 (Ind. Tax Ct. 1994)). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Caterpillar, Inc.*, 15 N.E.3d at 583.

Indiana imposes a tax on the adjusted gross income tax of every corporation that conducts business in Indiana or has income derived from Indiana. IC § 6-3-2-1(b); IC § 6-3-2-2. To compute the income subject to Indiana corporate income tax, Indiana adopts a multistep process to calculate a corporate taxpayer's taxable Indiana adjusted gross income. *Caterpillar, Inc.*, 15 N.E.3d at 581. Specifically, Indiana follows the tax principles established in the federal law. IC § 6-3-1-11. Indiana statutes refer to the Internal Revenue Code to efficiently and effectively compute what is considered the taxpayer's Indiana income tax. IC § 6-3-1-3.5(b) provides the starting point to determine a corporate taxpayer's taxable income, stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows" In determining the taxpayer's Indiana adjusted gross income, Indiana first refers to I.R.C. § 63 as the beginning point. From there, the taxpayer must follow various enumerated adjustments—additions and/or subtractions—under IC § 6-3-1-3.5(b).

Indiana also provides certain tax credits, outlined in [IC 6-3-3](#), which a taxpayer may claim to reduce its taxable income. Similar to deductions, exemptions, and exclusions "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009) (citing *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000)). The taxpayer who claims a tax credit against any tax is required to retain records necessary to substantiate a claimed credit. IC §

6-8.1-5-4(a); Treas. Reg. 1.41-4(d). Where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974).

One of the tax credits is the Indiana "Research Expense Tax Credit" for qualified research expense incurred for research conducted in Indiana pursuant to [IC 6-3.1-4](#). Specifically, IC § 6-3.1-4-1 (as in effect for the tax years 2007 - 2010), in relevant part, provides:

As used in this chapter:

"Base amount" means base amount (as defined in Section 41(c) of the Internal Revenue Code as in effect on **January 1, 2001**), **modified by considering only Indiana qualified research expenses and gross receipts attributable to Indiana** in the calculation of the taxpayer's:

- (1) Fixed base percentage; and
- (2) Average annual gross receipts.

"Indiana qualified research expense" means qualified research expense that is **incurred for research conducted in Indiana**.

"Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code **as in effect on January 1, 2001**).

"Research expense tax credit" means a credit provided under this chapter against any tax otherwise due and payable under [IC 6-3](#).

"Taxpayer" means an individual, a corporation, a limited liability company, a limited liability partnership, a trust, or a partnership that has any tax liability under [IC 6-3](#) (adjusted gross income tax).

(Emphasis added).

IC § 6-3.1-4-4 in relevant part references, I.R.C. § 41 "as in effect on **January 1, 2001**, and the regulations promulgated in respect to those provisions and **in effect on January 1, 2001**, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period." **(Emphasis added).**

"Qualified research" is defined in I.R.C. § 41(d), as follows:

- (1) In general.**--The term "qualified research" means research--
 - (A)** With respect to which expenditures may be treated as expenses under section 174,
 - (B)** Which is undertaken for the purpose of discovering information--
 - (i)** Which is technological in nature, and
 - (ii)** The application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
 - (C)** substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3). Such term does not include any activity described in paragraph (4).
- (2) Tests to be applied separately to each business component.**--For purposes of this subsection--
 - (A) In general.**--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.
 - (B) Business component defined.**--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--
 - (i)** held for sale, lease, or license, or
 - (ii)** used by the taxpayer in a trade or business of the taxpayer.
 - (C) Special rule for production processes.**--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).
- (3) Purposes for which research may qualify for credit.**--For purposes of paragraph (1)(C)--
 - (A) In general.**--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--
 - (i)** a new or improved function,
 - (ii)** performance, or
 - (iii)** reliability or quality.

(B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the following:

(A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.

(B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

(C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

(D) Surveys, studies, etc.--Any--

(i) efficiency survey,

(ii) activity relating to management function or technique,

(iii) market research, testing, or development (including advertising or promotions),

(iv) routine data collection, or

(v) routine or ordinary testing or inspection for quality control.

(E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--

(i) an activity which constitutes qualified research (determined with regard to this subparagraph), or

(ii) a production process with respect to which the requirements of paragraph (1) are met.

(F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

(G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.

(H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

(Emphasis is original).

Treas. Reg. § 1.41-4 (2001) further illustrates a "four-part" test to evaluate a claim for the qualified research expenses. Additionally, Treas. Reg. § 1.41-4(d) requires that,

A taxpayer claiming a credit under section 41 **must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.** For the rules governing record retention, see § 1.6001-1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits. **(Emphasis added).**

In other words, when a taxpayer claims that it is entitled to the research credits, the taxpayer is required to maintain and provide sufficient contemporaneous evidence in usable form and detail to support its qualified research activities, its qualified research expenses ("QREs"), and the factual connection (namely "nexus") between such qualified research activities and QREs. Generally, source documentation may include the taxpayer's accounting records and business administrative or operations records.

A taxpayer may participate in the IRS pre-filing program, using common cost-capturing methodologies pursuant to the IRS pre-filing agreement for federal QREs purposes but it bears the burden to demonstrate its QREs. See Internal Revenue Service, Large & Mid-Size Business Division, Office of Pre-Filing & Technical Guidance, *Research Credit Technical Advisor Program, Briefing Paper on Taxpayer Approaches to Capturing Costs for the Research Credit* (May 24, 2004) ("IRS Briefing Paper on Cost Capturing"), available at http://www.irs.gov/pub/irs-utl/cost_capturing_approaches_2004-05-24.pdf (last visited August 23, 2017).

The pre-filing program, however, is not available for Indiana income tax credit purposes. To be entitled to the Indiana RECs, in addition to satisfying the requirements established in I.R.C. § 41(b) and (d), a taxpayer must further demonstrate that it incurred the QREs for qualified research activities that occurred in Indiana.

The Department's audit in this instance disallowed Taxpayers' RECs as claimed in their Indiana returns for the Tax Years at Issue, explaining, in part, that:

[I]t is the documentation of the expenses relating to their Indiana activity that are in question, and whether

any of these activities and expenses they claimed qualifies under Indiana regulations.

The data provided by [Taxpayers] to substantiate the credit was not adequate. This data consisted of names of employees performing the research, job titles, [and] salary information, along with a description of the research activity taking place. The information lacked specificity, such as location of these employees . . . as well as whether supervisory personnel were directly involved with research . . .

For example, Taxpayers did not maintain adequate documentation and the Department was not able to examine the records concerning (1) What projects were claimed as Taxpayers' qualified research activities for the Tax Years at Issue? (2) How and why did those projects meet the four-part test pursuant to I.R.C. § 41? (3) How many and who were the employees that directly conducted the qualified research projects in Indiana? (4) How many and who were the employees that directly supervised the qualified research projects in Indiana? (5) How many hours did each qualified employee spend in performing the qualified services in Indiana? And (6) what were the costs of materials and supplies incurred in Indiana for the qualified projects?

The audit concluded that, even if assuming Taxpayers conducted qualified research activities, more Indiana specific information was needed, such as:

- Indiana UC-1 withholding forms which verify that employees engaging in research activities actually worked in Indiana . . .
- Information regarding the supervisory personnel, what their specific duties were, vis-à-vis the research supervision; were they "first line" supervisors . . .?
- Information to corroborate the 2[percent] fixed base percentage, and the data used to formulate it. Generally, it should be based upon the period from 1984-1988. If no research was done during that time, a predetermined rate of 3[percent] is used.
- Data to support the amount of supplies and equipment claimed for the credit.

Throughout the protest, Taxpayers argued that they were entitled to the Indiana RECs based on their estimates from the IRS audit result as well as its property and payroll information. To support their protest, Taxpayers offered additional documentation, as follows:

- Various employee's W2s for the Tax Years at Issue
- 2009 April "Quarterly Wage Report, Form UC-5A"
- Excel Workpaper Summarizing name, job title, and annual salary of each individual employee
- R&D Tax Credit Surveys for 2012 tax year
- Two-page Major Project Descriptions for one subsidiary
- Various news releases for another subsidiary

In addition, Taxpayers stated that they were audited by the Internal Revenue Service ("IRS") for the tax years 2006 through 2010. Taxpayers asserted that the IRS audit concluded that they had "a net increase in federal R&D credit." Taxpayers further claimed that, in 2014, they voluntarily participated in the IRS pre-filing program for claiming federal qualified research tax credit purposes. Relying on that 2014 "pre-filing agreement" with the IRS, Taxpayers argued that the IRS has accepted Taxpayers' accounting methodology - the "cost center" approach - for the purposes of claiming the qualified research expenses. Relying on the information mentioned above, Taxpayers maintained that the Department's audit erroneously disallowed their Indiana RECs for the Tax Years at Issue.

Upon review, however, Taxpayers' reliance on the above mentioned supporting documentation is misplaced. Specifically, as mentioned earlier, to claim the Indiana RECs, Taxpayers must demonstrate that the research activities they conducted in Indiana for the Tax Years at Issue were qualified research activities under IC § 6-3.1-4-4 (applicable for 2007 through 2010), which in turn, referenced I.R.C. § 41 "as in effect on January 1, 2001 and the regulations promulgated in respect to those provisions and in effect on January 1, 2001" See Letter of Findings 01-20150385 (December 12, 2016), 20170222 Ind. Reg. 045170090NRA (applied 2001 regulations and discussed the differences between 2001 regulations and 2004 regulations). Cf. IC § 6-3.1-4-4 (effective January 1, 2016). Taxpayers briefly described a four-part test in its May 31, 2017, letter, but their supporting documentation failed to demonstrate their activities met all elements of the four-part test under the 2001 statutory and regulatory requirements. Specifically, Taxpayers provided some information that was related to their 2012 research activities to support their research activities for the Tax Years at Issue (2007 through 2010). However, the Department was not able to agree that the 2012 information was adequate to substantiate that their 2007-2010 activities met the four-part test (the first step), and occurred in Indiana (the second step) for the purposes of QREs. Additionally, Taxpayers offered several news releases on new products. However, the

Department was not able to ascertain the scope and content of projects relevant to the QREs claimed in their Indiana returns under the four-part test as statutorily required, nor was the Department able to ascertain the calculations of the QREs. Without the required usable and verifiable records during the Tax Years at Issue to establish the "nexus" for the QREs or detail information of employees' involvement of certain qualified activities and relevant expenses that occurred in Indiana, the Department is not able to agree that Taxpayer was entitled to the claimed Indiana RECs for the Tax Years at Issue.

Second, Taxpayers claimed that the IRS audit result supported that they conducted qualified research activities for the Tax Years at Issue and thus then entitled to the Indiana RECs. Taxpayer is mistaken. Even if, for the sake of argument, assuming Taxpayers conducted various qualified research activities for the Tax Years at Issue, the IRS audit addressed the research activities conducted by Taxpayers' affiliates in the aerospace business. The IRS audit did not examine and therefore made no adjustments concerning Taxpayers' research activities occurring in Indiana, which were the activities in question under this protest. Taxpayers, in this instance, were not able to show a specific project or projects occurring in Indiana that were included in the IRS audit report and explain the information related to their research activities specifically occurring in Indiana as examined by the IRS.

Moreover, the Department is not able to agree that Taxpayers' pre-filing agreement, which was executed in August 2014, supported Taxpayers' claim of the Indiana RECs for the Tax Years at Issue. First, the pre-filing agreement was executed in 2014 and pursuant to that pre-filing agreement, the terms and conditions only applied to the 2013 - 2016 tax years, not the Tax Years at Issue. Second, the Department was not a party to that pre-filing agreement and had no opportunity to review or negotiate any terms and conditions to ensure the agreement complied with the Indiana statutory requirements regardless of applicable tax years. Lastly, the IRS only reviewed Taxpayers' documentation concerning the 2012 tax year, not the Tax Years at Issue, pursuant to the pre-filing agreement. Thus, Taxpayers' reliance of the pre-filing agreement for reporting its Indiana REC is beyond the scope of the protest.

Even if, for the sake of argument, that pre-filing agreement supported that the IRS has accepted Taxpayers' methodology, using the "cost center" approach rather than the "project base" approach to track their expenses, Taxpayers' supporting documentation failed to substantiate their Indiana RECs as claimed because their QREs were not verifiable. (The Department notes that Taxpayers seemingly asserted that they used the "cost center" approach to track their expenses in Indiana.) The "cost center" or "departmental" approach is "a logical grouping of activities that often follows the organizational structure of the company." IRS Briefing Paper on Cost Capturing, at 3. The "'cost center' approach tracks costs based on where within the company structure the cost was incurred." *Id.* Hence, the costs and activities do not necessarily relate to a specific research project for claiming QRE purposes. The IRS in its Briefing Paper explained, in part, that:

Although there is not necessarily a direct relationship between particular costs and activities within a cost center system (so that taxpayers applying this approach instead of the project approach face the burden of establishing that the activities undertaken within each of the cost centers are qualified research), each cost center does represent a limited pool of costs and activities that are related to one another in some way. *Id.* at 4.

In other words, Taxpayers may utilize whatever approach - "project based" or "cost center" - that affords themselves the most satisfactory result to better their business activities. However, to be entitled to the Indiana RECs for the Tax Years at Issue, Taxpayers must substantiate the Indiana RECs they claimed. Without the usable and verifiable source documentation, the Department is not able to verify the tax credit - \$1.63 million dollars - for the Tax Years at Issue regardless of the "cost center" approach which Taxpayers claimed was approved by the IRS in 2014.

As discussed earlier, Taxpayers bear the burden to demonstrate that they incurred qualified research expenses for conducting qualified research activities pursuant to the above-mentioned statutes and regulations and their qualified research activities occurred in Indiana. As the Department's audit noted that one of Taxpayers which claimed the Indiana RECs for the Tax Years at Issue was sold. Even if, assuming that the "cost centers" were properly designated and the IRS accepted the qualified cost centers listed by Taxpayers, their supporting documentation remained unusable and cannot be used to verify the Indiana QREs because they did not provide the detail information, such as invoices of costs of supplies and detail information concerning time (hours) of qualified employees who spent time on their qualified research activities in Indiana. Although it is entirely likely Taxpayer has qualifying activities, given the totality of the circumstances, in the absence of the usable and verifiable records for the Tax Years at Issue, the Department was not able to agree that Taxpayers were entitled to the Indiana RECs.

FINDING

Taxpayers' protest of the audit disallowance of the Indiana RECs issue is respectfully denied.

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